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Sales Tax on Services

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Existing Law:

- California's Sales and Use Tax Law currently imposes sales tax on retailers' gross receipts from the
 retail sale of tangible personal property in this state, unless the sale is specifically exempted or
 excluded from the tax. Additionally, local and district taxes are imposed under the Bradley-Burns
 Uniform Local Sales and Use Tax Law and the Transactions and Use Tax Law (and related
 provisions), respectively.
- Sales tax is generally not imposed on sales made by service providers; however, sales tax does apply to any services that are part of the sale of tangible personal property. When a transaction is regarded as a taxable sale of tangible personal property, tax applies to the gross receipts from the sale, without any deduction on account of the work, labor, skill, thought, time spent, or other expenses.

This Issue:

The topic of a sales tax on services is not new, but legislative inquiries on this issue have recently surfaced. Due to the nature of such a proposal and, if adopted, its substantial impact on the Board of Equalization's (BOE) administrative processes, this fact sheet serves to highlight the more significant administrative issues and offers options to consider.

Administrative Issues:

- BOE will incur significant costs. The BOE's operations will be significantly impacted if a tax on services is implemented. The BOE currently has over one million registered taxpayers who report sales tax on tangible personal property sales. Extending a broad-based tax on service providers' sales could add millions of additional taxpayers—the largest expansion of BOE's scope and role since sales and use tax was first established in the 1930s. To effectively administer a services tax, adequate funding is necessary for the BOE to hire, house, and train staff, identify and register affected businesses, make programmatic changes, respond to taxpayer inquiries, provide outreach to taxpayers, perform audit and collection functions, establish effective refund and appeals programs, and perform other administrative duties. Litigation costs would also increase due to general complexities associated with a tax on services.
- Extensive outreach and taxpayer educational efforts would be necessary. A broad-based tax on services would require mass notification, educational efforts, and outreach services in a short period of time. Substantial lead time would be imperative to achieve an adequate level of voluntary compliance. Properly informing and educating millions of service providers would be a monumental undertaking, yet one that is key to effective tax administration. More complex service-related industries would require additional outreach efforts to educate such taxpayers on proper tax application.
- Adequate lead time is critical. To effectively implement and administer a services tax, the BOE must have adequate lead time to perform necessary functions incidental to the tax. For example, a 12-month lead time would NOT provide sufficient time to prepare for and administer a broad-based tax. Also, any expansion should be timed to ensure the BOE's Centralized Revenue Opportunity System

(CROS) project is successful and fully implemented. CROS replaces the BOE's legacy computer systems and will maximize the effectiveness of staff operations, generate millions in previously unidentified revenue, and provide efficiencies that will benefit California businesses. A significant expansion of the BOE's administrative functions before implementation of CROS is not recommended.

- **Definitions of taxable and nontaxable services must be clear and comprehensive**. To reduce ambiguity and potential audit disputes, it is imperative that any statutory language adequately define the precise services and service providers that would be subjected to the tax.
- A services tax would have difficult apportionment issues. A tax on certain services provided to or by interstate businesses raises uncertainties in determining the portion of the service performed in California, and any proposed legislation should sufficiently address this issue. For example, what portion of the charges for a national advertising campaign would be subject to a proposed tax in California?
- A complementary use tax should be imposed on services used or consumed in this state.

 Generally, if the sale of tangible personal property for use, storage or other consumption in California is not subject to the sales tax, such as when the property was purchased out-of-state, then California's use tax applies. The use tax was originally put in place to eliminate the competitive advantage out-of-state retailers would otherwise enjoy over California retailers. For the same reason, , it is advisable that any proposed legislation impose a complementary use tax on at least some out-of-state purchases of services which the California purchaser derives a benefit from, or uses, in this state. However, compliance will be low if California consumers have considerable difficulty understanding and calculating their new use tax obligations.
- A services tax could have nexus issues. It will be necessary to clearly explain what is required for retailers to have nexus with this state for purposes of imposing sales tax or a use tax collection obligation on the retailers. Depending on these provisions, there will be significant costs associated with registration, auditing, and collecting tax for service providers outside of California that may have nexus with this state. The number of out-of-state service providers that would be required to register in California would be significant.
- Different tax rate on sales of services and sales of goods adds complexity. There are a variety of
 businesses that sell both tangible personal property and services-- such as auto repair garages,
 cosmetologists, and hotels. Additionally, as discussed above, some sale of services by these
 businesses are already subject to sales tax as being part of the sale of tangible personal property.
 Separate tax rates, possibly on the same invoice, would add another level of complexity and
 confusion for businesses and consumers.
- Any proposed legislation should specify whether services sold for resale are taxable. Sales tax does not apply to tangible personal property sold to persons who purchase the property to resell—whether it is incorporated into the manufactured article to be sold, such as any raw material becoming a manufactured article's component part, or whether the property is simply resold prior to intervening use. Any proposed legislation should address whether similar treatment would apply to service sales that are resold. For example, when a law firm hires an independent expert for services related to a case, and subsequently bills the client for these charges, would tax apply to the expert's charges to the law firm as well as the law firm's charges that are passed on to the client, so that the independent expert's service is taxed twice?
- How to treat sales of tangible personal property to service industries. Currently, those engaged
 in service industries are generally consumers of tangible personal property used in performing
 services. Sales of tangible personal property to them are not sales for resale and are generally subject

- to tax. Will amendments to the Sales and Use Tax Law be made to allow these service providers to purchase property for resale when that property is used in their now taxable services?
- Digital transmissions of goods and services are currently not subject to sales tax. If lawmakers contemplate imposing a tax on charges for digital downloads, it is advisable that the statutory language specify the circumstances under which those charges are taxable. For example, if a California purchaser vacationing in New York downloads a music file from a firm headquartered in California, and the music is sent to the California purchaser via a server in Oklahoma, would the charge be taxable?
- Local jurisdictions may not have authority to impose sales or use tax on services under the local and district tax laws. Current local tax and district tax laws state that the sales tax imposed under the respective laws is for the privilege of selling tangible personal property at retail. Extending the local or district tax base to include the sale of services could be contrary to these ordinances' language. Under these circumstances, the rate for the sales tax on services will be different from the rate for sales of tangible personal property in any jurisdiction that has an applicable district tax.
- The financial impact on service providers who would be required to register and report sales tax cannot be minimized. It would be necessary for service providers to maintain point-of-sale systems, or similar software, to account for and properly remit sales tax. The cost for such systems would cause significant hardship in many cases. In addition, future audit and/or other tax liabilities due to delayed compliance, non-compliance, or simple misinterpretation of how tax applies would be detrimental to many service providers.
- Impact on state and local government entities. As significant consumers of services, all levels of government would be impacted by a tax on services.
- **Potential for referendum or repeal.** If a tax on services is suspended or ultimately repealed, the state may not recover costs associated with the expansion. Four states—Florida, Massachusetts, Maryland and Michigan—all enacted and then later repealed a tax on services.
- Underground economy. A sales tax on services would dramatically grow the state's multi-billion
 dollar underground economy, requiring greater investments of time and resources to combat it by the
 BOE and other state and local government agencies.
- Auditing challenges. Many of BOE's programs rely on access to traditional brick and mortar retail
 facilities. For example, the BOE's Statewide Compliance and Outreach Program (SCOP) has teams
 located throughout the state that conduct door-to-door visits to businesses. However, in the new
 economy with many service providers working out of their homes and/or who travel extensively, a
 services tax would create additional challenges for BOE auditors and SCOP team members.

Options to Consider:

- To simplify administration, any proposed legislation should avoid a blanket tax on all services. Rather, the service providers selected for taxation should be those that are readily identifiable, such as those that must possess a license to sell services, or providers that sell both tangible personal property and services, such as hair dressers or auto repairers who would already be registered with the BOE.
- For administrative ease and simplicity, a tax on services should adhere to California's current sales and use tax model, to the extent practical and feasible.
- Apportionment issues can be minimized by limiting a service tax to providers that have some physical tie to California, such as services provided:

- To humans or animals physically located in California, e.g., dry-cleaning, haircuts or grooming, and parking.
- o In connection with property located in California, e.g., installation or repair labor.
- o In connection with real property in California, e.g., janitorial services.
- In connection with events occurring in California, e.g., tickets or admission, charges for sporting events, concerts, or movies.
- Any proposed legislation should allow service providers to make nontaxable service and property purchases only when those services and property are resold to a customer. As an alternative, any proposed legislation could require service providers to pay tax on such purchases and claim a credit for the tax paid when those purchases are resold directly to their customers.
- Occasional sellers or service providers with de minimis sales should be excluded from a proposed services tax to reduce administrative costs and minimize burdens on small sellers.
- To address complexities associated with a different tax rate on sales of services and sales of tangible
 personal property, legislation could require that the services tax rate be the same combined rate
 imposed in each taxing jurisdiction on tangible personal property sales. A portion of the tax collected
 could be allocated to local jurisdictions, if desired. Any legislation should be specific, however, on
 how the tax is allocated.